

DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER 98-0125
FOR TAX PERIOD: 1995 and 1996

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ISSUES

1. Corporation Income Tax

Authority: IC 6-2.1-3-24.5; 45 IAC 1.1-3-11; and IRC §1361(b).

Taxpayer protests assessment of Indiana corporation gross income tax for tax years ending 3/31/95 and 3/31/96.

2. Tax Administration—Negligence Penalty

Authority: IC 6-8.1-10-2.1; 45 IAC 15-11-2(c)

Taxpayer protests the imposition of the ten percent (10%) negligence penalty.

STATEMENT OF FACTS

The taxpayer was incorporated under Indiana law in January, 1993. The taxpayer's principal business is painting racecars and other vehicles used in the racing industry. The taxpayer also does body work for individuals who are not involved in the racing industry. The taxpayer filed Special Corporation Income Tax Returns for the tax years included in the audit. Additional relevant information will be provided below as necessary.

I. Corporation Income Tax

DISCUSSION

Indiana Code 6-2.1-3-24.5 and 45 IAC 1.1-3-11 provide that “[f]or purposes of this section, ‘small business corporation’ has the same definition that term has in Section 1361(b) of the Internal Revenue Code.” IC 6-2.1-3-24.5. In relevant part, Section 1361(b) of the Internal Revenue Code states: “the term ‘small business corporation’ means a domestic corporation which is not an ineligible corporation and which does not—(D) have more than 1 class of stock.”

The auditor concluded the taxpayer did not qualify as a special corporation because it had issued more than one class of stock. As evidence of this, the auditor cites the following:

1. For the fiscal year ending 3/31/95, the stockholder’s equity section on the taxpayer’s balance sheet shows 50 shares of preferred stock issued and outstanding at a value of \$5,000. For the fiscal year ending 3/31/95, the stockholder’s equity section also shows 10,000 shares of common stock issued and outstanding at a value of \$10,000.
2. The Articles of Incorporation the taxpayer filed with the Indiana Secretary of State’s office authorizes both common and preferred shares. The Articles authorize 10,000 shares of common stock and 1,000 (7%) shares of preferred stock.
3. For the fiscal year ending 3/31/96, the stockholder’s equity section on the taxpayer’s balance sheet shows common stock issued and outstanding at a value of \$15,000.00. Since the articles of incorporation had not been amended, the auditor concluded that the \$15,000 in capital stock was still a combination of \$5,000 of preferred shares and \$10,000 of common shares.

In June, 1995, the taxpayer’s preferred shareholder sued the taxpayer and its chief executive officer, claiming, among other allegations: 1) taxpayer had never issued a stock certificate to the shareholder; 2) corporation had not made required monthly principal payments as per its subscription agreement; 3) corporation had not provided quarterly financial statements; and 4) corporation had not made quarterly payments as per the agreement. The shareholder received a default judgment, with an order for the taxpayer and its chief executive officer to pay damages awarded by the court.

Taxpayer argues that, since no preferred stock was ever issued and was not, therefore, outstanding, taxpayer qualifies as a special corporation because Treas. Reg. §1.1361-1 requires stock to be issued and outstanding before a corporation may be denied special corporation status for tax purposes. However, a careful reading of Treas. Reg. §1.1361-1 shows that such a restrictive reading would only be justified, if ever, only in reference to stock “that is issued in connection with the performance of services....” Treas. Reg. §1.1361-1.

Taxpayer also argues that the “alleged preferred shareholder was never treated as a preferred shareholder but rather a creditor.” March 24, 1998, Letter of Protest. Taxpayer further argues the subscription agreement for the preferred stock was more of a loan than a stock purchase. Taxpayer alleges that, based upon its award, the court also concluded the subscription agreement provided for a loan rather than a stock purchase. Taxpayer concludes that since it never treated the “alleged preferred shareholder” as a preferred shareholder, it therefore had no preferred shareholder.

The default judgment entered against the taxpayer and its chief executive officer does not reach the merits of the plaintiff’s complaint. The court did not consider the merits of the complaint because taxpayer failed to enter an appearance in the matter. The taxpayer’s Article of Incorporation, its balance sheets, and its past behavior are much more instructive in determining the taxpayer’s corporate status than is the taxpayer’s treatment of its shareholder.

FINDING

The taxpayer’s protest is denied.

II. Tax Administration – Imposition of Negligence Penalty

DISCUSSION

Taxpayer protests the imposition of the ten percent (10%) negligence penalty. The negligence penalty imposed under IC 6-8.1-10-2.1 may be waived by the Department where reasonable cause for the deficiency has been shown by the taxpayer. Specifically:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

Because the position taken by the taxpayer with respect to the denied issue was not unreasonable, waiver of the negligence penalty is warranted.

FINDING

Taxpayer’s protest is sustained.